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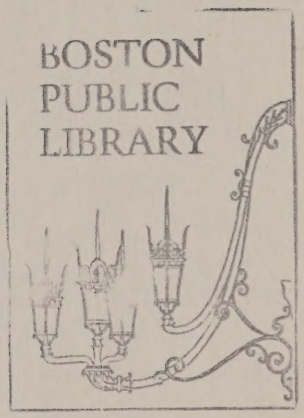
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TIGHTENING CREDIT FOR COMMERCIAL DEVELOPMENT; SURVEY OF PRE-LEASING REQUIREMENT FOR CONSTRUCTION LOANS

Alexander Ganz
John Avault
Robert Amatruda

Policy Development and Research
Boston Redevelopment Authority

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A survey of developers, real estate brokerage firms, and banks, conducted from mid-July to early August, reveals the recent emergence of formidable and worrisome constraints on interim construction lending for commercial development. These newly emerging limitations on the availability of bank credit for commercial construction hold the danger of severely restricting development in Boston.

In earlier years, banks used to require 30 to 40 percent pre-leasing as a prerequisite for interim commercial development construction loans. When the building was completed, permanent long-term mortgage financing was arranged. From 1979 to 1989, more than 12 million square feet of Class A office construction in Boston was financed under variants of this general arrangement.

The just completed survey indicates a severe breakdown in the operation of the credit system for financing development. In the two week period, dating from the third week in July, a sample of developers, real estate brokerage firms and banks were asked "What is the current pre-leasing requirement for construction loans?". Following is a listing of some of the responses; names of respondents and firms have been omitted to respect privacy.

Developers

1. Every situation is different. Two months ago, 40-50% pre-leasing was required; now it is 50-60% for projects with rents banks believe in. Banks have become much more conservative, and quite stringent on (1) rents anticipated, (2) time for lease-up, (3) reserve for contingencies. There is a whole different mind-set in the banking community. The traditional 1.1/1 ratio of cash flow to debt won't fly now. The bank regulators are tougher. There is now concern about the Basle Accord which, in 1992, will require greater capital equity.

   The situation will vary, market to market. Conditions will be better in Boston.

   Commercial banks now have more long-term loans than life insurance companies which are now not interested in permanent loans.

   Developer projects 3 to 5 years for the lending market to return to normal, nationally, and 2

to 3 years in Boston.

Developer is optimistic about Boston, - diversified economic base, - health care, higher education, services.

2. Sixty percent pre-leasing spells trouble. The project has 42% pre-leasing, but their bank is not impressed, requiring a 100% guarantee by the company. A take-out lender would require 50% pre-leasing, but the terms would be onerous. They were giving the financing try one last shot.

3. The developer of a project in Dallas, a $300 million, 1 million square foot building, 50% pre-leased, was asked to provide a $75 million equity, and a $75 million guarantee.

For their Boston project, their pre-lease objective is 25-50%. The risk is in the low-rise space. Vacancy rates in the high-rise floors are low. The task is to lease 250,000 square feet of low-rise space. Otherwise, they would be subject to poor deals. They could provide a 100% guarantee, but they would risk their company, and they wouldn't do that. They are targeting low-rise in their marketing. Significant guarantees and equity will be required. For another project, they have been talking to CITICORP and other lenders.

Of the 150,000 square foot project, 100,000 square feet of pre-leasing would be required, along with significant equity and guarantees.

4. Developer guesses 100% pre-leasing is needed today, or substantial leasing, in excess of 50%, plus equity. He is having difficulty refinancing his space. Hancock and Prudential have turned him down. They won't lend in the Northeast. He is having difficulty obtaining a 5-year loan for a 93% leased project, with a prime tenant.

5. Forty percent pre-leasing is required by those banks still making construction loans. Some banks will not consider lending for the construction of speculative space. Banks will now use a 65% loan to value ratio, requiring more equity, and recourse provisions are tougher. Lending depends on the nature of the real estate, the location, and the partners. A 50 percent guarantee is frequently required. Some loan agreements stipulate earnings outcome provisions with equity converted to loans when specified criteria are met. Some types of office construction, especially suburban projects, cannot be financed at all.

6. Fifty to ninety-five percent pre-leasing is required, depending on the market and product; the norm is 65%. The specific market is examined closely. Developer is operating in the suburban market only, and has no projects in the city.

7. Banks require high pre-leasing, over 60 percent. Many banks now will not lend for office projects. Banks may require enough pre-leasing to cover their loan.

8. Banks will not make construction loans unless there is a permanent lender committed. One-third to one-half pre-leasing is required. Developer has not been in the market for construction loans this year.

9. Forty to fifty percent pre-leasing is required. There is pessimism abroad about Massachusetts. We've done a poor job in informing people on our low office vacancy rate. All we read is bad news stories.

   There is skepticism about the strength of the economy.

10. Question is irrelevant because there are no deals being made. "I know of projects almost entirely leased or committed that can't get going. Either there is something "wrong" with a tenant, some numbers marked down, or something".

11. 80% pre-leasing is required; 100% in fringe areas, varying deal by deal, with equity important.

12. The bad news is that banks require 40-50% pre-leasing. The good news is the same. Developer believes in slowing development now, to protect rents and market values. He notes that with rents in the mid-20s and costs at $350 a square foot, the numbers don't work out.

Real Estate Brokerage Firms

1. Real Estate Brokerage Firm leader was a construction lender once. Twelve to fifteen years ago, the process started with a developer signing up a tenant, then obtaining a construction loan, then providing equity to bridge the gap between building cost and the construction loan, and, when the building was completed, converting the interim funding into permanent financing. In the 1980s, things changed, construction loans were open ended, tenants would sign up, and the permanent loan lined up when the building was completed. Now we are back to where we were twelve to fifteen years ago. Fifty to sixty percent pre-leasing is now required. And there are fewer construction lenders in business.

2. An example presented at a breakfast meeting of the Real Estate Finance Group, Greater Boston Real Estate Board, was cited. A $285 million office building, 60% pre-leased, found the maximum obtainable was a $190 million (67%) non-recourse loan, in Atlanta.

Banks and Financial Advisers

1. There is no lending today for speculative space. 100% pre-leasing is required, in comparison with 50% in ordinary times.

   The work-out officer, says the next 6 months will not be pleasant.

2. There are no rules of thumb today; it was 30% to 50% two months ago. The window is closed until the market clears. There is not a lot of inventory.

3. Banks used to require 30 to 40 percent pre-leasing for projects. Now the requirement is close to 100 percent pre-leased, if a bank would even consider backing a project. No more speculative buildings are financed. The loan would be a function of the amount of capital equity in the project, rental levels, and construction costs.

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